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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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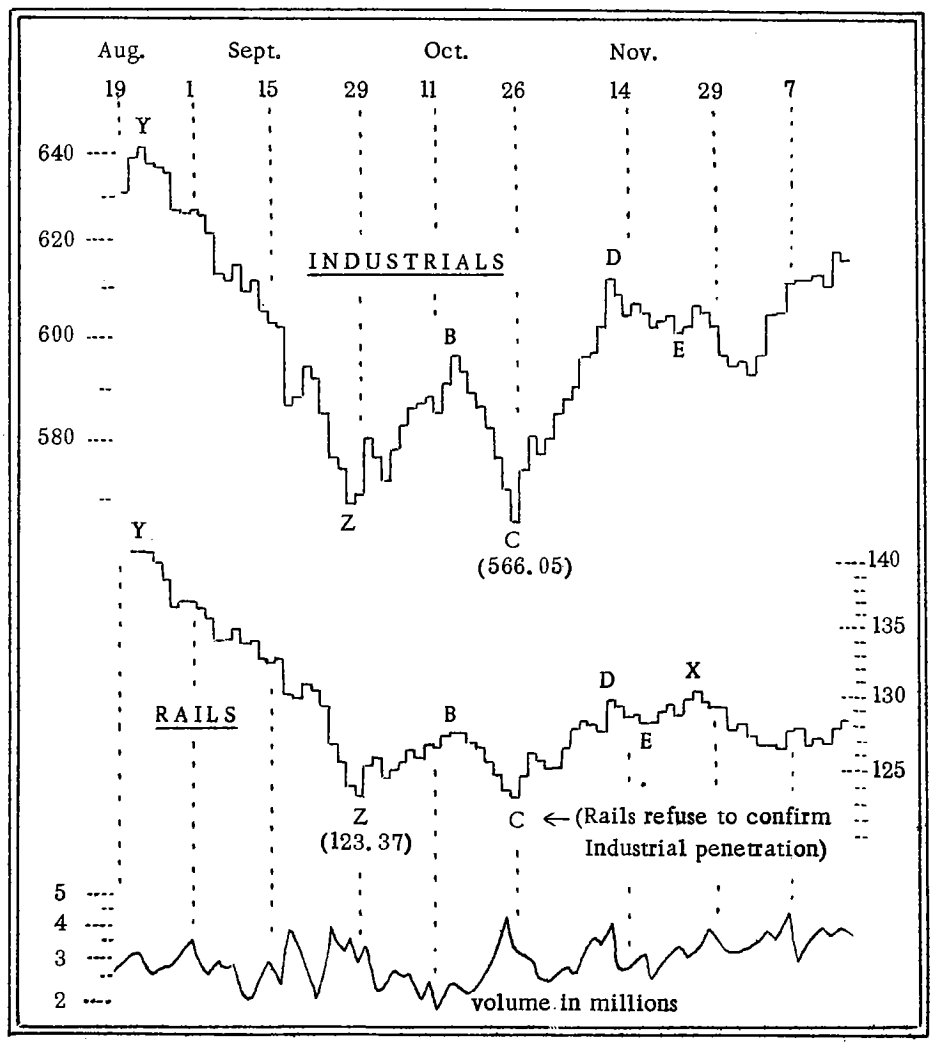
PRICE MOVEMENTS Letter 121 noted that at point C (Oct. 25) Rails refused by 14¢ to confirm the downside penetration of Industrials through the preceding Z level. "Reversals," continued Letter 121, "have often been signalled by the refusal of one Average to confirm the penetration of the other."

Letter 122 went on to say, "... if the B points are jointly bettered, particularly on increasing volume, the secondary trend will be pointing up for the first time since June. In this case the odds favor a normal 1/3 to 2/3 correction of the ground lost from T (Industrials 656.42) to Z (Industrials 566.05)."

That thought was amplified in Letter 123: "Normally, secondary reactions tend to correct 1/3 to 2/3 of the losses sustained during the preceding primary leg. The current advance has already exceeded the minimum normal expectation. The maximum normal expectation (although it is never wise to dogmatize) would be a rally to 626."

In duration, secondary reactions tend to last three weeks to three months. According to Dow Theory a move is taken to have ended at the spot where the Averages register their last confirmed highs or lows. The last confirmed lows of this bear market occurred at Z (Sept. 28), following which the intermediate trend turned bullish. This means that the current advance (since Z) has lasted just short of three months. As of this writing Industrials have retraced 56% of the losses sustained on the preceding primary leg, while Rails have retraced 30%. From the standpoint of both time and duration, the rally has reached the proportions of a normal secondary reaction. Moreover, the time and duration of the current advance suggest that the movement should be coming to an end.

In the last Letter I drew attention to the pronounced divergence in the two Averages. Since then, despite the strength in Industrials, Rails have refused to confirm by bettering point X (130.13). A study of the 64 year history of the Averages suggests the wisdom of caution when the two indicators disagree as to direction.



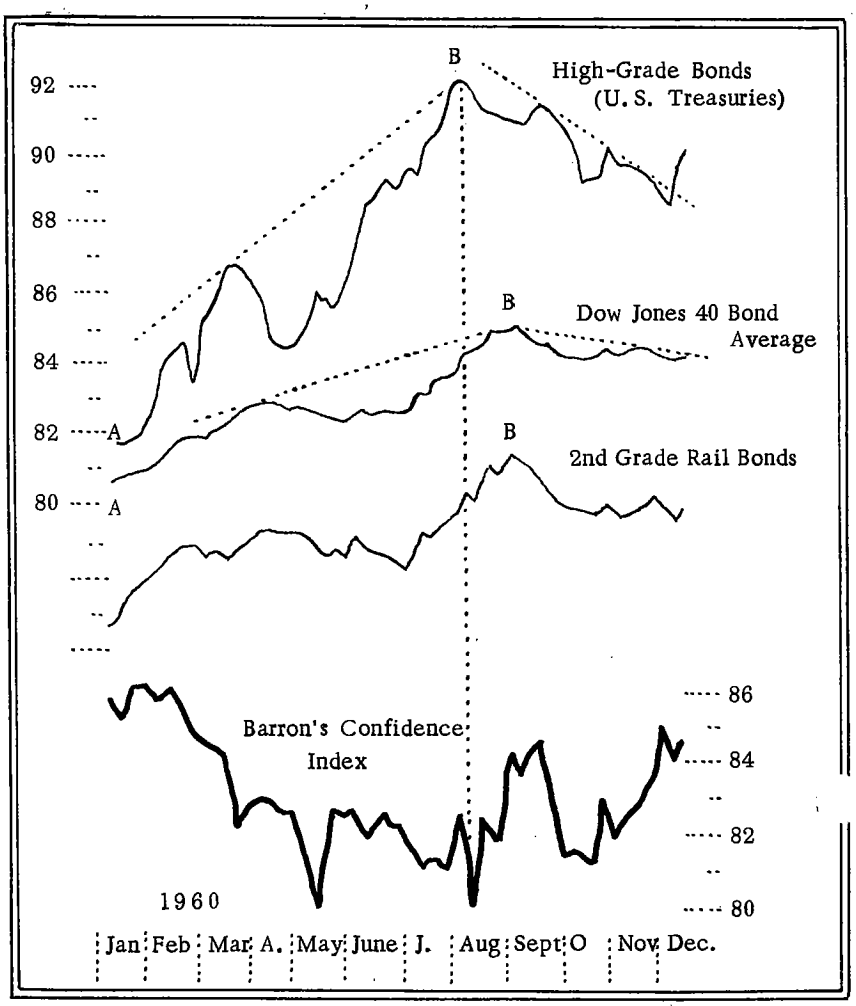
If the industrial segment of the economy is to improve, if more cars, homes and appliances are to be manufactured, then more steel, coal, ore, lumber, etc.will be needed. If this fundamental expansion is to take place, the rail (transportation) sector of the economy should improve in anticipation of a forthcoming increase in carloadings.

In the event that Rails confirm by bettering 130.13 (preferably on increased volume), the secondary uptrend will be reconfirmed. This could bring in renewed interest in some of the depressed cyclical issues such as steels, rails, metals, rail equipment and machinery. In general, however, the longer the time lag before final confirmation, the less authoritative the confirmation.

Personally, I would rather see (as did Rhea) a penetration take place with some force. I would be skeptical of a penetration which occurred (1) on diminishing volume, or (2) on a day of divergence. Rhea often said that he preferred to see an upward penetration which came following a slight dip rather than one which came at the end of a long series of advancing days.

INSIDE THE CONFIDENCE INDEX (C.I.) Over the last few months I have received dozens of inquiries concerning Barron's Confidence Index, and this seems like a good time to discuss that indicator. The C.I. is merely the ratio of the yields on Barron's 10 Highest Grade Bonds to the broad Dow Jones 40 Bond Average. The theory is that when informed investors turn bullish they will foresake safety (as represented by Barron's 10 Highest Grade Bonds) in favor of higher yields (as represented by the D-J 40 Bonds). Conversely, when investors turn bearish they will foresake attractive yields in favor of the highest grade bonds and safety. In the bearish case, the C.I. will decline as the ratio of the yields on the two averages adjusts. The converse is true in the case of optimism.

The movements of the C.I. are supposed to precede broad stock movements by 2 to 4 months (sophisticated bond money theoretically moves before equity money). I have made a caref study of the C.I., and I have come to the following conclusions: (1) the basic concept of the ratio of high-grade bonds to ordinary bonds is a valid one. (2) In practice, the timing factor of the C.I. is so variable as to be extremely difficult to follow. (3) The C.I. is most valid when it indicates the direction of forthcoming stock movements, least valid when indicating extent. (4) The trend of the components of the C.I. is more useful than the actual movements of the C.I.



The accompanying chart shows the movements of Barron's U.S. Treasury Bond Average (which is comparable but more sensitive than Barron's 10 Highest Grade Bond Average), the movements of the D-J 40 Bond Average and the movements of the D-J 2nd Grade Rail Average. The ratio of the Treasury Bond Average and the 40 Bonds represents the fundamental force behind the C.I. (which is shown at the bottom of the chart). It is important to understand that the 2nd Grade Rails are by far the most volatile components of the D-J 40 Bond Average, and I have included the 2nd Grade Rail Average to illustrate

that point. Often, the greatest part of a movement in the 40 Bond Average is the result of a violent movement in 2nd Grade Rail Bonds. For instance, between 1929 and 1932 the 40 Bonds declined 32% while their volatile component, the 2nd Grade Rails declined 54%. Again in 1936-37 the 40 Bond Average declined 3.8% while the 2nd Grade Rails declined 14.6%. Note on the chart that during 1960 the 2nd Grade Rails have again moved faster than the 40 Bond Average.

From point A in January, 1960 to point B, the high-grade Treasuries moved broadly upward (see chart). During the same period the 40 Bond Average advanced but at a much slower rate. This produced a steady decline in the C.I. From May through July the 40 Bonds actually declined against the rising Treasuries and this produced the low of 79.9 in the C.I. (May). In August the Treasuries spurted violently upward while the 40 Bonds trended gradually higher and this provided another low reading of 80 on the C.I.

At point B, however, all the Bond Averages turned down, and here again the high grades moved faster than the 40 Bonds. From mid-October onward the 40 Bonds flattened out while the Treasuries continued to drop to a low in early December. This produced a recovery high of 85.1 in the C.I.

Two weeks ago high-grade Treasuries broke above their descending trendline, while the 40 Bond Average and its fast-moving component, the 2nd Grade Rails, dropped to their lowest level since July, 1959. This divergence produced a drop of a full point in the C.I. (Dec. 12). If the 40 bonds follow their declining trend and the Treasuries or high-grade bonds continue to rally (or hold), the trend of the C.I. will be down. Conversely, if Treasuries turn weak while the 40 bonds hold or rally, the C.I. will turn bullishly higher. With it all, however, this observer is still not convinced that the ratio of the yields of the bond averages can consistently and repeatedly foreshadow movements in the equity markets.

BEAR MARKETS Waiting for the Averages to render their next decision can fray the nerves of the most hardened investor. During the upward correction of a long downward swing, the writer of a letter such as this is subject to excellent arguments on every side. My friend Eliot Janeway (the economist-writer) has been about as correct on the recent business picture as any man I know. He told me a week ago that the economy is about to be hit by what he terms "all-at-once-itis" (from all direction, according to Mr. J.). A subscriber and veteran market student, Mr. G.A. Trapp of St. Joseph, Mo. writes as follows: "The market is quite marvelous in its action considering half the world is on fire and in turmoil, base commodities are declining, foreign competition vicious, deficit in balance of payments, the gold standard in jeopardy, confiscation of foreign property, the U.N. and its value defunct, an election, a change of administration, permanent unemployment, sluggish three quarters of business and many other things without doubt incorporated in the judgment of the Averages. What then is ahead to shape the market, war? War alone seems the only possible element to rock the Averages, God forbit." Much of what Mr. Trapp says is true, but it is also true that every major swing in the Averages is subject to a normal 1/3 to 2/3 correction. Moreover, Rails have not yet confirmed the upward course of Industrials, and until they do, the Industrial rally can not be considered to have any forecasting value whatever.

No two bull or bear markets are exactly alike, either as to cause or effect. Broadly speaking, bear markets make their appearance whenever corporate profits and sales are due to contract over an indefinite period of time. Dow's Theory does not attempt to predict the severity of a forthcoming contraction in business. For instance, a bear market began in April, 1899, and it resulted in the Industrial Average's depreciating a mere 29% while Barron's Business Index slid from 102 to 88. Another bear market started in March, 1937, and this contraction wiped out 49% of the value of the D-J Industrials while Barron's Business Index slumped from 88.8 to 56.4. The factors contributing to both bear markets were varied and complex, and it is doubtful whether economists today can agree as to the basic cause of either downturn. In general, it can be said that important recessions in the economy are always preceded by generous doses of inflation. By the same token, the deflation which inevitably follows inflation is heightened by the unwillingness or inability of people to spend or take on new commitments.

The modern concept of "Governmental stabilization of the economy" is based on the theory that if you make more money available to individuals and corporations, that money will be spent. But in every cycle there comes a time when "the horse won't drink any more water", and no amount of enticement will change his mind. Along these lines, The New York Times ran the following breathless headlines atop a story in its Sunday financial section (Dec. 11, 1960): "Housing Is Losing Its Cyclical Role -- Industry Yielding Position as Recuperative Factor in Business." Translated this means, "Mortgages are easier to obtain, but what's wrong with the

people? Why don't they start buying houses again?" If the present trend continues it will undoubtedly have many a "modern" economist scratching his head. It's been a long time since John Public has put incoming funds in the savings bank instead of into a new washer-dryer at 10% down and 32 weeks to pay.

"JUMPING THE GUN" A subscriber (R. Himes, Arcadia, Calif.) writes: "If, following the termination of the present intermediate rally now underway, both Averages experience a decline lasting three weeks or more but which stops short of the closing lows registered in September and October in at least one of the Averages, following which both Averages then rally again to close above the tops soon to be established, would you not then be obliged to report that the primary trend had once again changed from bull to bear?"

The correspondent is obviously a student of the market, and the question he asks is a good one. The formation described is the mechanical plotting of a bull signal. In the event that such a pattern is formed in the near future, I would certainly not want to own shorts. At the risk of appearing stubborn or inconsistent, however, I would also be extremely nervous about assuming more than a token "long" position. Following a movement of one or both Averages to new bear market lows, any succeeding day of advance can conceivably mark the beginning of a new bull market. Nevertheless (and while not claiming infallibility), the reasons for my skepticism regarding the possible bullishness of the present situation are as follows: (1) The decline in Industrials has wiped out 17.5% of the value of that Average in a period of 15 months. This would seem to be an unusually short and shallow correction of a ten year bull market (during which Industrials advanced 524 points). (2) We have not seen a period of extremely low volume (which is so typical of bear market bottoms). (3) The average yield on the D-J Industrials is more suggestive of a major top than a bottom (yields have held in the 2.9% to 3.9% area since late 1958). (4) There is still too much bullishness around to suggest a bear market bottom. I do not know of a single important investment service which is bearish, while most of the recent bearish services have now turned bullish.

In the end, however, each man must "kill his own snakes". If the two Averages were to decline over a period of three or four weeks (with one or both Averages holding above the bear market lows), and, following this, if both Averages then rallied over the preceding secondary high points, the indication would be sufficiently bullish to warrant at least modest purchases of stocks. This approach may appear to be overly conservative, but in the absence of the five listed factors (any or all of which might indicate a normal bear market bottom), I would not be inclined to "jump the gun".

NOTICE The current issue of Barron's (Dec. 19) contains an article by the writer entitled "Will History Repeat?". The piece compares the present situation with that of 1957-58, and I believe it will be of interest to all subscribers.

To all my subscribers, both in America and in foreign lands, and to all those market students with whom I exchange services, letters and ideas -- a Merry Christmas and a happy New Year.

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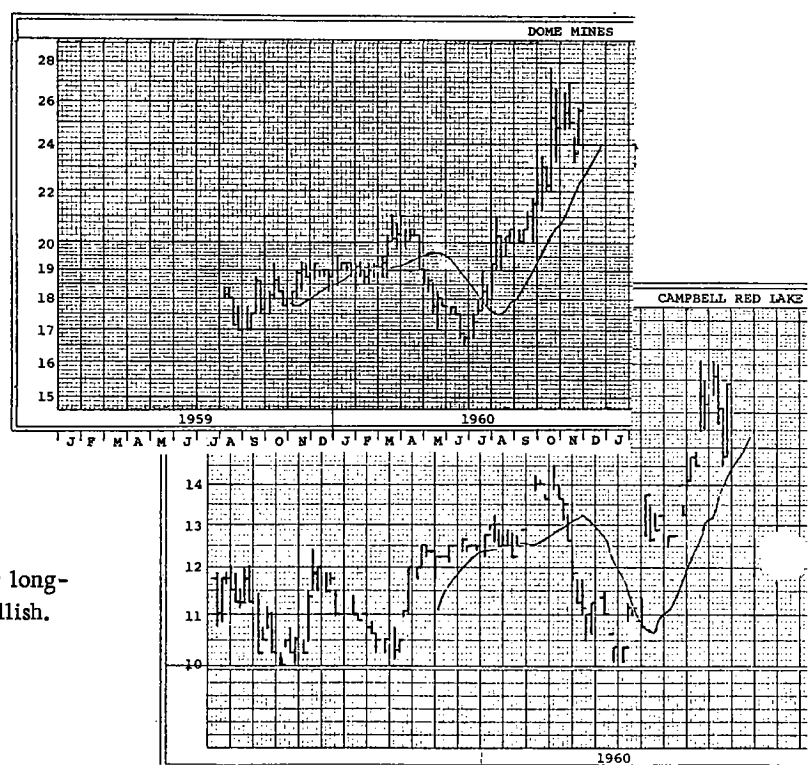

Iain Fraser of "Stock Market Trends" (159 Bay Street, Toronto, Canada) shows charts of the golds plotted against a ten week moving average (the moving average is drawn three weeks ahead of the price movements). The charts show both Campbell and Dome continuing to hold above their long-term average. If they continue to do so, they will remain bullish.

(Written Tuesday, December 20th, 1960 - 2 P.M.)